United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

75-7203

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
NO. 212 - SEPTEMBER TERM, 1975
DOCKET NO. 75-7203

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

v.

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

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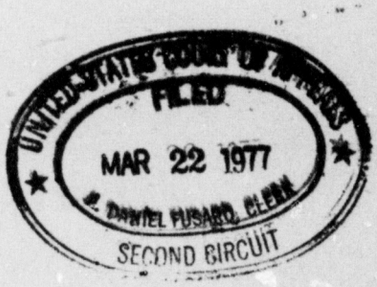

BRIEF OF STEINHARDT, BERKOWITZ & CO. AMICUS CURIAE

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12

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BRIEF OF STEINHARDT, BERKOWITZ & CO.

AMICUS CURIAE

PRELIMINARY STATEMENT

This brief is submitted on behalf of Steinhardt, Berkowitz & Co., a limited partnership ("SBC"), as amicus curiae on a rehearing of the decision and judgment of this Court, dated February 25, 1977 (the "Decision").

SBC is a private investment partnership, generally similar in form to defendant Fleschner Becker Associates ("FBA"). Unless revised, the Decision could have a substantial adverse

effect on SBC and a large number of other investment partnerships,[1] as well as upon innumerable other internally-managed firms and entities,[2] for it has already been interpreted as calling into question the long-established exemption from registration as investment advisers, relied upon by the general partners of private investment partnerships, and investment personnel of other internally managed firms and entities, since the adoption of the Investment Advisers Act of 1940, 15 U.S.C. 80b-1, et seq.(the "Advisers Act").

ISSUES DISCUSSED

To assist the Court upon rehearing, SBC will address itself to but two critical issues not treated in the briefs submitted on appeal:

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1. There appears to be no comprehensive current information concerning the number, size and structure of private investment partnerships. However, the Staff of the Securities and Exchange Commission (the "Commission") conducted a survey in 1969 among unregistered investment partnerships, as part of a comprehensive study of institutional investors. See SEC, Institutional Investor Study Report, H.R.Doc. No. 92-64, 92d Cong., 1st Sess. 283-324, 369-374 (the "Institutional Investor Study Report"). The 140 partnerships surveyed (of which 127 were limited partnerships) had total assets of $1.3 billion as of December 31, 1968. Id. at 284, 290. It is estimated that today such partnerships are fewer in number.

2. Although the Decision involved solely an investment partnership, its reasoning would apply readily to almost any form of self-managed entity, including other types of partnerships, investment companies (both registered and unregistered), pension funds, joint ventures, family and other trusts, holding companies, closely-held corporations, joint accounts and proprietary trading arrangements, and to their respective officers, directors, agents, trustees and administrators. As shall be demonstrated herein, the validity of investment arrangements involving billions of dollars of assets could be potentially affected by the Decision.

1. The general partners of an investment partnership do not "advise others", but are principals of a self-managed investment entity (the partnership itself) and are members of a class of individuals not intended to be covered by the Advisers Act as "investment advisers".

If general partners are held to be investment advisers, their "client" (for purposes of determining whether they must register as investment advisers under Section 203 of the Advisers Act) is, presumptively, the partnership itself, and not the limited partners. The Court need not decide under what circumstances, if any, the "clients" may be the limited partners (which is a factual issue) since it is open to the Court to hold that the limited partners of FBA have a private right of action under Section 206 of the Advisers Act, without concluding or implying that they are "clients" of the general partners.

POINT I

GENERAL PARTNERS ARE INTERNAL MANAGERS OF AN INVESTMENT COMPANY IN PARTNERSHIP FORM AND, LIKE TRUSTEES AND DIRECTORS OF INTERNALLY MANAGED CORPORATE INVESTMENT COMPANIES, ARE NOT INVESTMENT ADVISERS WITHIN THE MEANING OF THE ADVISERS ACT

The Decision holds that the FBA general partners are "investment advisers" because they (i) received "compensation" and (ii) were "engage[d] in the business of advising others" by sending monthly reports to the limited partners and "by exercising control over what purchases and sales are

made with their clients' funds" (Slip Op. at 6223, 6226).

The same may be said of trustees of trusts, officers and directors of corporate investment companies, general partners of brokerage firms and others, who similarly are compensated for so acting, regularly report to their beneficiaries, shareholders or partners, and exercise investment discretion over the investment of their funds, and who are not, have never been, and were never intended to be, investment advisers for purposes of the Advisers Act. This is because neither they, nor the general partners of FBA, "are in the business of advising others" (Advisers Act, Section 202(a)(11)).

An analysis of the relationship of the Advisers Act to the Investment Company Act of 1940, 15 U.S.C. 80a-1, et seq. (the "Investment Company Act") is a necessary starting point to understand the "advising others" concept.

The Advisers Act was enacted in conjunction with, and ancillary to, the Investment Company Act.[3] The Investment Company Act was concerned with the regulation of investment companies, trusts and other investment vehicles, and

3. The Advisers Act was enacted as Title II of Public Law No. 768, 76th Cong., 3d Sess. (1940), then known as the Investment Company Act, which term presently refers solely to Title I of that law. It is apparent from the hearings that the predominate Congressional concern was with the regulation of investment companies, and that the Advisers Act was, in essence, an attempt to compile information concerning investment counsel and similar firms, rather than the comprehensive scheme of regulation envisioned by Title I. See, inter alia, S.Rep. No. 1775, 76th Cong., 3d Sess. (1940)(the "Senate Report"); H.Rep. No. 2639, 76th Cong. 3d Sess. (1940); Jaretzki, "The Investment Company Act of 1940", 26 Wash.U.L.Q. 303 (1941).

their respective advisers and other affiliated persons. The Advisers Act, on the other hand, was concerned with external advisory firms, principally persons and firms acting as investment counsel to a broad range of clients.[4] Congress did not intend the coverage of the two Acts to overlap; in the final legislation, investment vehicles, and their related personnel, were to be regulated solely under the Investment Company Act.[5]

The critical fact, overlooked in the discussion of legislative history in the amicus curiae brief of the Commission (the "Commission Brief"), was that Congress intended the term "investment adviser" to exclude internal investment managers of entirely self-managed investment vehicles, such as officers, directors, agents or other employees. This intent is embodied in the definition of "investment adviser" set forth in Section 2(a)(20) (then Section 2(a)(19)) of the Investment Company Act, which, in pertinent part, states:

> "'Investment adviser' of an investment company means (A) any person (other than a

4. The Advisers Act was directly based upon the results of a Commission survey of investment advisers. See Senate Report at 27. That survey covered investment counsel firms, serving a wide variety of clients, of which investment company clients were relatively few in number. See generally, SEC, Report on Investment Trusts and Investment Companies (Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services), H.R.Doc. No. 477, 76th Cong. 2d Sess. (1939) (the "Investment Counsel Report").

5. Thus, an investment adviser to a registered investment company was specifically exempt from registering as an investment adviser under the Investment Advisers Act, under Section 203(b), which was not altered by Congress until 1970.

> bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities ..." [emphasis supplied][6]

This definitional exclusion has been recognized by both the courts and the Staff of the Commission.[7] Today no less than eleven registered investment companies, internally managed by their officers and directors, rely upon the exclusion so that their managers are not "investment advisers", under either the Investment Company Act or the Advisers Act, even though they perform all investment management services for such companies.[8]

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6. Sections 28(6) and (7) of the Securities Acts Amendments of 1975 provided that, as used in Sections 9 and 36, respectively, of the Investment Company Act, "the term 'investment adviser' includes a corporate or other trustee performing the functions of an investment adviser". It is significant that Congress determined that such a specification was necessary, and did not choose to broaden the "investment adviser" definition in either the Investment Company Act or the Advisers Act.

7. Kleinman v. Saminsky, 200 A.2d 572 (Del. Sup. Ct. 1964), aff'g Saminsky v. Abbott, 194 A.2d 549 (Del. Chanc. Ct. 1963), cert. den. 379 U.S. 900 (1964); Coi.Vest, Inc. [73-74 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶79,823 (1974).

8. According to the Wiesenberger Investment Company Service, the following funds are among such "internally managed" funds: Madison Fund, Inc.; Niagara Share Corporation; National Aviation Corp.; Petroleum Corp. of America; The Adams Express Company; Central Securities Corp.; Consolidated Investment Trust; Standard Shares, Inc.; The United Corporation; U.S. and Foreign Securities Corp.; and General American Investors Co. Although, as noted in note 5 above, by reason of the 1970 amendments, an investment adviser to a registered investment company is no longer exempt from registration under the Advisers Act, the position apparently taken by these funds, consistent with the Congressional intent and accepted by the Commission, is that the "internal manager" exclusion in Section 2(a)(20) of the Investment Company Act is implicit within the Advisers Act definition, so that internal management personnel are not "investment advisers" required to register under that Act.

The Congressional intent to exclude self-managed vehicles is similarly reflected in the definition of "investment adviser" in Section 202(a)(11) of the Advisers Act, which includes:

> "... any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities ..." [emphasis supplied]

The critical words, "advising others", were overlooked in the Commission Brief. A review of the legislative history of the Advisers Act illustrates that internal managers of investment entities were not considered as among the persons intended to be covered by that Act.[9] Thus, there is no anomaly in holding that the internal managers of an investment company are not investment advisers; indeed, the statutory scheme expressly so provides.

Private investment partnerships have long been recognized as investment companies which are exempt from registration

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9. As noted above, the Advisers Act was directed towards the persons surveyed in the Investment Counsel Report. That Report expressly excluded from its coverage such persons as trustees, who were not engaged "primarily in the business of furnishing investment counsel or advice". Investment Counsel Report at 1, n. 1. Moreover, the Report specifically implies that internal managers of investment companies were not regarded as among the persons to be surveyed: "A majority of the investment companies covered in the Commission's study ... which were managed by persons or organizations other than the officers and directors of the investment companies, were managed or supervised either by ancillary management companies or pursuant to management contracts between the investment company and the sponsors ..." Investment Counsel Report at 9 (emphasis supplied).

under the Investment Company Act.[10] A general partner of an investment partnership is analogous to a director of a corporate investment company and, in fact, meets the statutory definition of "director" in the Investment Company Act.[11] It follows that if an investment partnership were registered under that Act, its general partners would be excluded from the definition of "investment adviser" under both the Investment Company Act and the Advisers Act. Under the regulatory pattern envisioned by Congress, the same result should obtain with regard to an investment company not required to register. It would be an illogical and inequitable result to find that the general partners of an investment partnership, which is expressly exempt from registration as an investment company, are nonetheless "investment ad-

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10. Section 3(c)(1) of the Investment Company Act exempts "Any issuer whose outstanding securities...are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities..." Although Section 3(c) states that such persons are not investment companies, it is clear that this is exemptive language and that such partnerships, in the absence of such exemption, would satisfy the "investment company" definition set forth in Section 3(a) of the Act. The reliance by private investment partnerships upon this exemption has long been recognized by the Commission. See, e.g., Institutional Investor Study Report at 290, n. 120.

11. Section 2(a)(12) of that Act defines "director" to include persons "performing similar functions" to that of a director, in the case of non-corporate entities. In considering the registration of partnerships under the Investment Company Act, the Staff of the Commission has consistently regarded general partners of a limited partnership as "directors" within the meaning of the statutory definition. See, e.g., Brian A. Pecker (October 3, 1974); Carolina Palmetto Income Investors (February 22, 1974).

visers", although they perform the same management function as their non-adviser counterparts at registered companies.

In two early decisions, the Commission specifically recognized the Congressional intent by excluding internally managed entities from the definition of "investment advisers".[12] These decisions remain valid.

Moreover, in managing the partnership's assets, general partners act as principals for the partnership. They may be directly compared with the trustees of an investment trust. The Commission has held that such a trustee is not an investment adviser, within the meaning of the Advisers Act (In re Loring, 11 S.E.C. 885 (1942)), as has a district court in this Circuit. In Selzer v. Bank of Bermuda Ltd., 385 F. Supp. 415 (S.D.N.Y. 1974), Judge Pollack expressly rejected the argument that a trustee of an investment trust was an "investment adviser" under the Advisers Act:

> "... The trustee does not advise the trust corpus, which then takes action pursuant to its advice; rather the trustee acts himself as principal. While there may be public policy reasons for holding a trustee who deals in securities for its trust to the standards of the Investment Adv sers Act, neither the common sense meaning of the word "adviser" nor a comparison with other situations to which the 1940 Act has been held applicable militates in favor of doing so." 385 F. Supp. at 420.

12. In the Matter of Roosevelt & Son, Investment Advisers Act Release No. 54 [1948-52 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,016 (1949)(general partnership); In the Matter of The Pitcairn Company, Investment Advisers Act Release No. 52 [1948-52 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,990 (1949)(closely held corporation).

Judge Pollack's interpretation of the statute is sound. There has been no demonstration of policy reasons for stretching the Advisers Act to cover such persons as general partners and trustees. They are already firmly bound to the highest fiduciary standards.[13] If the general partners of investment partnerships -- or the trustees of trusts, administrators of estates and pension plans and investment officers of corporate investors -- are to be regulated as "investment advisers", that change should be made by legislation.[14] This Court should not

13. It is a long accepted principle of partnership law that a general partner is bound as a fiduciary to the limited partners. Riviera Congress Assoc. v. Yassky, 18 N.Y.2d 540, 277 N.Y.S.2d 386, 233 N.E.2d 876 (1966). Each limited partner has a separate, personal cause of action against the general partners for fraud and misconduct. Millard v. Newmark & Co., 24 A.D.2d 333, 266 N.Y.S.2d 254 (1st Dept., 1966). In addition, any limited partner may bring an action on behalf of the partnership charging a general partner with breach of fiduciary duty. See N.Y. Partnership Law (McKinney) §115-a; Riviera Congress Assoc. v. Yassky, supra. Similarly, the law imposes a strict duty upon a trustee to act with utmost fidelity for the benefit of the trust beneficiary. In re Hubbell's Will, 302 N.Y. 246, 97 N.E.2d 868 (1951); Bankers Trust Co. v. U.S., 308 F. Supp. 545 (S.D.N.Y. 1970).

14. It is significant to note that in proposals to amend the Investment Advisers Act, first submitted by the Commission in December, 1975, Congress responded by suggesting, among other things, that the Commission should conduct a study "of the extent to which persons who are not included in the definition of investment adviser, or who are specifically excluded from the definition, are engaged in investment advisory activities," including persons exercising investment discretion with respect to securities accounts. See S.2849, Sec. 10, 94th Cong., 2d Sess. (1976); S.Rep. No. 94-910, 94th Cong., 2d Sess. 11 (1976). It is noteworthy that S.2849, as well as the bill originally proposed by the Commission, would amend Section 203(b) to eliminate the "intrastate exemption" from registration, but would not affect the paragraph (b)(3) exemption critical to this case.

expand the definition of investment adviser beyond the scope which it has been given in the statute or in any prior judicial or Commission interpretation in the 36 years since the enactment of the Advisers Act.

POINT II

IF GENERAL PARTNERS ARE "INVESTMENT ADVISERS", THE "CLIENT" IS PRESUMPTIVELY THE PARTNERSHIP AND THE COURT SHOULD NOT DECIDE UNDER WHAT CIRCUMSTANCES THE "CLIENTS" ARE THE LIMITED PARTNERS SINCE THAT IS A FACTUAL ISSUE WHICH IT IS NOT NECESSARY TO RESOLVE FOR THE LIMITED PARTNERS TO HAVE AN IMPLIED RIGHT OF ACTION UNDER THE ADVISERS ACT

The holding of the Decision was that the general partners of FBA were "investment advisers", within the meaning of Section 202(a)(11) of the Advisers Act (Slip Op. at 6213). However, in a footnote dictum (relating to the question of whether FBA was a proper defendant), the Court noted that "... the general partners as individuals, not FBA as an entity, were the investment advisers to the limited partners" (Slip Op. at 6226, n.16). Nowhere in the Decision, the dissent of Judge Gurfein or the briefs does there appear any discussion or rationale for the footnote language.

The general partners of SBC, as well as other general partners and internal managers of investment vehicles, have always believed that if they were investment advisers, their "client" was the partnership, a recognized legal entity the

assets of which they manage, rather than the limited partners.[15] Accordingly, they have relied upon the exemption from registration set forth in Section 203(b)(3) of the Advisers Act.[16] The Commission has been aware of, and has acquiesced (through its inaction) in, this practice for many years.[17] In December 1976, the Staff of the Commission stated its position that limited partnerships would, in general, be regarded as single clients for purposes of the registration provisions of the Advisers Act.[18] Furthermore,

15. Cf., inter alia, Hawes, "Hedge Funds", 23 Bus. Lawyer 576 at 580 (1968). This position is consistent with recognized principles of partnership law, such as the fact that each partner has an interest in the partnership as a whole, and not in specific partnership property. See, e.g., Riviera Congress Assoc. v. Yassky, supra n. 13. Accordingly, a partnership may be distinguished from such entities as investment clubs and pooled accounts, where each investor retains title to his assets invested, and, arguably, should be treated as a separate "client".

16. This provision exempts from registration, "Any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under Title I of this Act."

17. See Institutional Investor Study Report at 290, where it was noted that of 127 limited partnerships surveyed, 73 (including 26 of the 27 largest firms) had 15 or more limited partners.

18. Ruth Levine (December 15, 1976). The Staff, in a response concerning the Section 203(b)(3) exemption, noted that "Generally, we recognize limited partnerships as legal entities. However, if the partnership was organized by an adviser, or an affiliate of the adviser, the members of such partnership would probably each be counted in determining how many clients the adviser was serving..." (Stanley B. Judd, Assistant Chief Counsel, Division of Investment Management). The Staff "organizational approach" appears based upon the assumption that advice is given in forming the partnership, and not upon any ongoing management or reporting function. See remarks of Ezra Weiss, "Investment Partnerships and 'Offshore' Investment Funds" (PLI, 1969). Even this li-

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the structure of the Advisers Act itself does not support such a strained interpretation.[19]

The relationship of the FBA general partners as asset managers to FBA cannot be functionally, logically or legally distinguished from that of hundreds of investment company asset managers who have but one client -- the investment company itself.[20]

It should be emphasized that if the Court, upon rehearing, finds that limited partners have a private right of action under Section 206 of the Advisers Act, it is not necessary for the Court to conclude that the limited partners are "clients" of the general partners for purposes of the registration provisions of Section 203. The Advisers Act provides that a person who is an investment adviser is subject to the anti-fraud provisions of Section 206, even if he is exempt from re-

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mited approach, however, is questionable, since it suggests that all "self-underwritten" issuers are investment advisers -- a position finding no support in the Advisers Act, the legislative history or industry practice (for example, investment companies are not regarded as "investment advisers" simply because they distribute their own shares).

19. Thus, certain rules promulgated under the Act appear inconsistent with a view that the limited partners could be separate "clients". For example, the general partners could not "segregate the assets of each client" (as required by Rule 206(4)-2), if each partner were a client, since a partner has, in effect, an undivided interest in all partnership property. Note 15, supra.

20. We do not maintain that general partners are never investment advisers to the limited partners. But a finding to that effect should be predicated upon a factual determination that the general partners intended to act as investment advisers and held themselves out as so doing, and utilized the partnership as a vehicle for handling individual clients -- i.e., if the partnership entity is created for, and used as, a subterfuge for providing investment advice to individuals. The approach of the Staff on this question (see discussion at note 18, supra) clearly indicates that the Staff also views the determination of the "client" to be a sensitive issue of fact.

gistration under Section 203.[21] Moreover, it is certainly open to the Court to hold that limited partners have a private right of action under Section 206, without concluding or implying that they are "clients" of the general partners for purposes of Section 203.[22] On the other hand, a reaffirmation of the footnote statement would have profound and far-reaching consequences, for it would open to question whether the general partners of investment partnerships may continue to be "unregistered", whether they may continue to be compensated on a percentage of the investment gains of the partnership,[23] and, indeed, whether

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21. The amendments to the Advisers Act in 1960 (S.3773) accomplished this result. Significantly, in extending Section 206 to advisers exempt from registration, Congress did not see fit to restrict or eliminate the registration exemptions themselves. As noted in the legislative history, Congress reaffirmed the desirability of permitting certain registration exemptions to continue. See S. Rep. No. 1760, 86th Cong., 2d Sess.7 (1960).

22. Indeed, under the test enunciated by the Supreme Court in Piper v. Chris-Craft Industries, Inc., 45 U.S.L.W. 4182 at 4192 (Feb. 22, 1977), i.e., whether plaintiffs are within the "class of persons for whose especial benefit the statute was enacted", it is clear that the Court could find that the plaintiffs are within such class, without necessarily finding that they are "clients". As noted in the Commission Brief, the Advisers Act had as its specific objective "to protect the public and investors against malpractices by persons advising others about securities", and this class could be construed as broader than the term "client", which implies a direct and separate contractual relationship. See also J.I. Case Co. v. Borak, 377 U.S. 426 at 432 (1964), where the Supreme Court implied a private right of action in favor of class of persons far broader than that suggested by notions of contractual privity.

23. Section 205(1) of the Advisers Act prohibits a registered investment adviser from being compensated "on the basis of a share of capital gains or upon capital appreciation..."

partnership agreements which provide for such compensation are themselves valid under the Advisers Act.

CONCLUSION

For the foregoing reasons, it is urged that the Court, upon rehearing, hold that the general partners of FBA are not "investment advisers" within the meaning of the Advisers Act. If the general partners are held to be investment advisers, the Court is urged either to find that the "client" of such advisers was FBA, not the limited partners, or otherwise to refrain from determining that the limited partners were "clients" of the general partners, as that term is used in Section 203 of the Advisers Act.

Respectfully submitted,

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March 22, 1977

CERTIFICATE OF SERVICE

Service of a copy of the annexed Brief of Steinhardt, Berkowitz & Co. Amicus Curiae was made upon the following counsel for the parties herein by placing same in the United States mail, postage prepaid, this 22nd day of March 1977:

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